

4. Coordination with USAID and Other Donors.

In developing the Rural Development Project, the Parties investigated the work of the donors described below in an effort to ensure that the Rural Development Project complements, and does not duplicate, replace or harm, such work.

The U.S. Agency for International Development ("USAID") has three projects that relate to or may support the Rural Development Project: (i) the *Centro Desarrolla Agricultura* (CDA) project, which is run by a private company, Fintrac, to increase sales, incomes, employment of, and local investment in, the Honduran agribusiness sector by providing market-oriented technical assistance to producers and processors; (ii) the Productivity and Policy Enhancement Program project, which serves to strengthen the National Banking and Insurance Commission's supervision of financial private voluntary organizations, transition such organizations into the regulated banking environment, and help stimulate commercial banks to lend to small businesses and rural producers; and (iii) the Development Credit Authority, which signed two portfolio guarantee agreements targeted at providing guarantees of up to 50% of loans to micro, small and medium enterprises.

The U.S. Department of Agriculture ("USDA"), through Food for Progress donations to the Honduran Ministry of Agriculture, funded: (i) the National Agribusiness Development Centers program; (ii) the Sanitary and Phytosanitary Systems Animal and Plant Health program; and (iii) the implementation of recommendations produced from agricultural roundtable discussions. USDA also has a program with Technoserve to assist small farmers in northern Honduras, and has begun to fund a similar program in southwestern Honduras. The 2005 Food for Progress donation is expected to be used to help corn farmers transition to new crops, continue improvements to the Sanitary and Phytosanitary Systems Animal and Plant Health program, and further develop value-added chains.

The World Bank (i) funded the first phase of a land titling project (PATH) that will automate, consolidate and make property information more publicly accessible, and (ii) approved a loan to recapitalize the deposit insurance fund and reduce systemic risk in the banking sector, among other objectives.

The Inter-American Development Bank ("IDB") funded the Government's principal integrated rural development program (PRONADERS), which used such funds to implement (i) the RERURAL project that invested in irrigation, milk collection and refrigeration centers, coffee "green" projects, rural electrification, rural highways, and water and sanitation projects, and (ii) the MARENA project that invested in local initiatives such as basin management, irrigation systems, livestock production, reforestation, and environmental protection. The IDB also (i) finances a watershed management project, and (ii) has provided complementary support in plant and animal disease control for imports and exports and for agricultural policy work.

The International Fund for Agricultural Development ("IFAD") also funded PRONADERS, which used such funds to finance (i) the PROSOC project in southwestern Honduras and (ii) the PRONADEL project that focuses on local development. PRONADERS assists rural families to

finance agricultural production, livestock activities, irrigation systems, and improving rural infrastructure.

The Canadian International Development Agency ("*CIDA*") funds the ProMesas project that assists farmers in the Olancho region and finances forestry development projects in northern Honduras.

5. Sustainability.

The implementation of the Rural Development Project is designed to support the development of local capacity (yet maintain tight fiduciary risk controls) by providing Honduran professionals and institutions with experience in implementing the Program. This design is expected to add to Honduras' soft infrastructure — the human capital base that is essential for the successful design, management, and oversight of public and private projects. The Rural Development Project will use qualified staff within SAG to procure services needed to implement the Program.

While all contracts will be open to international bidding, local and regional firms are expected to be very competitive in most activities. Even in activities where an international firm may win the contract, there will be opportunities to employ Honduran individuals or firms under those contracts. For example, the Farmer Training and Development activity will be designed to allow for the participation of local firms while ensuring they work under the supervision of an internationally qualified Agribusiness Service Provider. As another example, the rural roads supervisory firm will be selected through international competitive bidding, but the construction contracts will be relatively small contracts in which national and regional firms will be very competitive.

The key issue with respect to financial sustainability of the Rural Development Project is ensuring that Program Farmers who graduate from the program are able to maintain their level of productivity under the Program and expand their business. Farmers who have successfully absorbed the intensive transformational Agribusiness Assistance will then have sufficient income to pay for less intensive periodic technical assistance to allow them to keep current with future innovations in agronomy and changes in the market structure for agricultural products. Equally important, marketing and agro-export businesses often are willing to provide technical assistance and inputs (e.g., seeds) to producers once those producers are established.

The Program promises to increase the supply of credit to stronger rural borrowers. Those farmers who have successfully learned how to access credit and have established a credit history will be in a better position to access credit in the future, thereby creating a larger demand for financial services. As bankers expand to profit from this demand, they will develop the financial products and contract the required expertise (e.g., agronomists) to service this growing market. Similarly, expanded horticultural production will create economies of scale that reduce the unit costs of inputs and post-harvesting services.

The key to ensuring environmental and social sustainability of the Program is ongoing public consultation to ensure optimal design and implementation and to ensure full country-ownership

of the Program. The Environment and Social Impact Director ("*ESI Director*") within the PMU will ensure that environmental and social mitigation measures (including resettlement and gender issues) are followed for all Project Activities in accordance with the provisions set forth in the Compact and other documents. The ESI Director also will serve as the point of contact for comments and concerns of Project-affected parties regarding the implementation of all segments of the Compact, and lead the effort to find feasible resolutions to those problems. The ESI Director will convene periodic public meetings to provide implementation updates and to identify and address public concerns.

6. Policy and Legal Reform.

The Parties have identified the following policy, legal and regulatory reforms and actions that the Government shall pursue in support, and to reach the full benefits, of the Rural Development Project, the satisfactory implementation of which will be conditions precedent to certain MCC Disbursements as provided in the Disbursement Agreement:

(a) Pass the Access to Credit Law (*Ley para facilitar el Acceso al Credito*) to improve the process for pledging collateral and foreclosing on liens and other security interests in collateral; and

(b) Maintain a clear policy stance against the adoption of any action that limits or otherwise alters the original terms of an obligation of any borrower to repay a properly documented loan obligation without the agreement of the lender.

To improve its level of performance under the policy criteria identified in Section 607 of the Act and the MCA Eligibility Criteria, the Government will pursue the following legislative and policy reforms:

(a) Enact new anti-trust legislation that reduces constraints on commerce and competition;

(b) Enact new civil service legislation, issue the corresponding regulations, appoint the head of the new civil service supervisory authority, and satisfactorily implement the new law; and

(c) Reform the civil procedures code to make all new lawsuits more transparent and expeditious by making them oral and public.

SCHEDULE 2 to ANNEX I

TRANSPORTATION PROJECT

This Schedule 2 generally describes and summarizes the key elements of a Transportation Project in furtherance of the Transportation Objective (the "*Transportation Project*"). Additional details regarding the implementation of the Transportation Project will be included in the Implementation Plan and in relevant Supplemental Agreements.

1. Background.

High transportation costs are a significant impediment to economic growth, particularly for agriculture and light manufacturing. Consequently, the PRS proposed an ambitious plan to strengthen the Honduran primary, secondary and rural road network. This fits within the broader strategy developed in the Plan Puebla-Panama ("*PPP*") to create a reliable Mesoamerican network of highways known as the International Network of Mesoamerican Highways. This network comprises two main corridors on the Atlantic and the Pacific (the "*Atlantic Corridor*" and "*Pacific Corridor*," respectively) and a series of complementary routes. Under this initiative, member countries have pledged to work toward harmonizing transportation regulations and standards, modernizing customs procedures and border crossings, and strengthening airport security. The Atlantic and Pacific Corridors are vital to the integration of Central America and will have a significant economic impact on this region by creating an efficient connection between the production centers in Central America and major port facilities on the Atlantic and Pacific Oceans.

The 1,746 kilometer Atlantic Corridor links Mexico, Belize, Guatemala, Honduras and El Salvador. The Honduran portion of the Atlantic Corridor includes (i) portions of the CA-5 Norte Highway (the "*Highway CA-5*"), which carries most of Honduras' import and export traffic between Puerto Cortes and the major production and consumption centers in and around the cities of San Pedro Sula, Comayagua and Tegucigalpa, and (ii) a new road that will connect Comayagua directly to the Pacific Corridor and the Pacific port facility at Puerto Cutuco in El Salvador. The 294 kilometer Highway CA-5 carries most of the country's import and export traffic and accounts for 23% of highway traffic volume. After more than 30 years of service, the road needs improvements as service levels have declined drastically on some stretches and road safety is poor. Average annual traffic volume on the Highway CA-5 varies between 5,400 and 8,300 vehicles, with a high proportion (35%) of heavy vehicles.

Many productive areas in Honduras are connected to the main road arteries by unpaved secondary roads, whose uneven surfaces do not permit rapid transit. These poor roads cause high vehicle operating and maintenance costs and spoilage of delicate products, which undermines the competitiveness of the producers who must use them. These roads also are expensive to maintain, requiring periodic re-grading following the rainy season. For these reasons, the paving of high-volume secondary roads is a profitable investment which contributes decisively to the competitive potential of the areas they serve.

Since the mid 1990s, Honduras has not had a system for controlling weights and measures in place for its roads network. The lack of a system of control of weights and measures contributed

to the premature deterioration of the roadways, increasing the cost of maintenance and reducing safety. A recent study found that 23% of passenger and cargo vehicles carry excessive weight. Trucks with more than 2 axels record the most excess weight, and these also represent a large percentage (41%) of vehicles that travel through the national roads. Excess weight significantly reduces the lifespan of roads and bridges, decreases the safety of the roadways and, as a result, increases the costs of maintenance programs.

2. Summary of Project Activities.

The Transportation Project is designed to reduce transportation costs between Honduran production centers and national, regional and global markets. The key activities of the Transportation Project include:

(a) Highway CA-5. The improvement of a 50 kilometer segment of Highway CA-5 between Taulabe and Comayagua (the "*North Segment*") and a 59 kilometer segment of Highway CA-5 between Villa de San Antonio and Tegucigalpa (the "*South Segment*").

(b) Secondary Roads. The upgrade of key secondary routes to improve the access of rural communities to markets.

(c) Weight Control System. The construction of an effective weight control system and the issuance of contracts to operate it effectively.

The following summarizes the contemplated Transportation Project Activities. The M&E Plan (described in Annex III) will set forth anticipated results and, where appropriate, regular benchmarks that may be used to monitor implementation progress. Performance against the benchmarks and the overall impact of the Transportation Project will be assessed and reported at the intervals to be specified in the M&E Plan or as otherwise agreed by the Parties from time to time. The Parties expect that additional benchmarks will be identified during the implementation of the Transportation Project. Estimated amounts of MCC Funding for each Project Activity for the Transportation Project are identified in Annex II of this Compact. Conditions precedent to each Transportation Project Activity and sequencing of the Transportation Project Activities shall be set forth in the Disbursement Agreement or other relevant Supplemental Agreements.

(a) *Activity: North and South Segments of Highway CA-5*

MCC Funding will support the following improvements to the North and South Segments:

(i) Construction along the North and South Segments, including building (A) a third ascending lane in highway segments of steep and sustained inclination, (B) "passing lanes" in high volume highway sections, (C) interchanges and bridges, (D) pavement construction, (E) appropriate entrance and exit lanes, and (F) parking bays for buses and other protection and security measures;

(ii) Making important geometrical changes to improve visibility and safety in curves in the North Segment and South Segment;

(iii) Utility relocations as may be necessary to accommodate the rehabilitation of the North and South Segments;

(iv) Drainage and environmental mitigation;

(v) Providing signage and other safety improvements;

(vi) Supervision over the construction activities described above; and

(vii) Compensation for individuals, residences and businesses affected by the rehabilitation of the North and South Segments consistent with the World Bank policy on Involuntary Resettlement.

The *expected results* from, and the *key benchmarks* to measure progress on, these activities are set forth in Annex III.

(b) *Activity: Secondary Roads*

MCC Funding will fund the paving of up to 91 kilometers of key secondary routes with a "double treatment" of asphalt to improve velocity and reduce maintenance costs.

Subject to the prior approval of MCC, MCA-Honduras will select secondary roads among the range of proposed roads that promise the highest economic rate of return among such roads, subject to the conditions that each selected road must:

(i) Conform to the Environmental Guidelines;

(ii) Conform to the World Bank policy on Involuntary Resettlement, where relevant,

(iii) Be fully designed to the satisfaction of MCA-Honduras and MCC;

(iv) Be properly documented to the satisfaction of MCA-Honduras and MCC, including a description of the location of the proposed road, necessary type of works, estimation of costs, a technical and economic assessment, and land acquisition required, including information on the status of the environmental and other requisite licenses; and

(v) Be consistent with the long-term plans of SOPTRAVI.

The *expected results* from, and the *key benchmarks* to measure progress on, these activities are set forth in Annex III.

(c) *Activity: Vehicle Weight Controls*

To increase road life and safety, MCC Funding will support:

(i) The construction of eight weight control stations along the Highway CA-5 or along major arteries feeding into the Highway CA-5, which areas MCA-Honduras shall select, subject to the prior approval of MCC, based on criteria that includes the proximity of areas that generate cargo, the level of traffic flow and the absence of means to easily avoid the controls set in place; and

(ii) The acquisition of ancillary weight control equipment.

The Government must enter into contractual arrangements with one or more private companies to administer the weight control stations and to charge fees to unload overweight vehicles. The selection of such private companies shall be through competitive, transparent bidding and hiring mechanisms. To guarantee the transparency and efficiency of the administration of the weight control system, the parties administering the system shall be subject to the following:

(i) Evaluations and control mechanisms of the personnel responsible for systems operation;

(ii) Reporting requirements on all income collected through fees;

(iii) Requirements that over-weight trucks be charged to reduce loads to legal standards;

(iv) Internal financial audits;

(v) External financial audits to be performed by one or more companies or firms selected through a public bidding process;

(vi) On-going technical audits performed by SOPTRAVI; and

(vii) A requirement to conduct periodic public awareness and information dissemination campaigns geared to informing users and the general public about the benefits of the weight control system, its operating procedures, and other necessary information.

The *expected results* from, and the *key benchmarks* to measure progress on, these activities are set forth in Annex III.

3. Beneficiaries.

The principal beneficiaries of the Transportation Project are expected to be (i) users of the improved roads by decreasing transportation costs to markets and social service delivery points (e.g., hospitals, schools); and (ii) employees and owners of urban and rural businesses that rely on the Honduran road network. The Transportation Project also promises to have a significant economic impact in the greater Central American region since it constitutes a key component of the Atlantic Corridor.

4. Coordination with USAID and Other Donors.

(a) Coordination during Project Development. In developing the Transportation Project, the Parties investigated the work of the donors described below in an effort to ensure that the Transportation Project complements, and does not duplicate, replace or harm, such work.

The World Bank is financing (i) the improvement of sections of the Highway CA-5 that are adjacent to the sections that MCC will improve, (ii) the reconstruction of several highways and bridges (including rural roads), (iii) a project with the Honduran Fondo Vial ("*Road Fund*") to use micro-enterprises for routine maintenance, and (iv) technical assistance to SOPTRAVI to support its planning unit and to strengthen the Road Fund to better ensure the sustainability of road investments.

The IDB is financing (i) the improvement of two sections of the Highway CA-5 that are adjacent to the sections that MCC will improve, (ii) the vehicle weight control study that informed the design of the vehicle weight control component that MCC will fund, and (iii) the Program for Sustainable Institutional Strengthening of the Road Sector, which seeks to institutionally strengthen SOPTRAVI to improve the quality of road construction, the reliability of resources allocated to the sector, road safety, and environmental management.

The Central American Bank for Economic Integration ("*CABEI*") is financing (i) the section of the PPP's Atlantic Corridor that connects the Highway CA-5 to the Pacific Corridor, and (ii) the section of the Atlantic Corridor between Puerto Cortez and the Guatemalan border.

(b) Coordination during Project Implementation. In an effort to ensure that the Government, MCC and the other financial institutions involved in upgrading the Highway CA-5 coordinate their efforts, the Parties and other donors are committed to instituting a mechanism for coordination, dialogue and exchange of current information among such parties. Consistent with what has already been established between other donors and the Government, SOPTRAVI will prepare a semiannual report on works in execution on the Highway CA-5 and distribute it to each participating institution. The report will indicate progress toward physical and financial targets for the projects funded by each donor, summarize the number, description and status of physical and financial progress under each works and supervision contract, and offer a brief summary of critical aspects encountered that might affect successful completion and achievement of objectives for each project at a given time. After the report is distributed, SOPTRAVI will convene a meeting of participating financial institutions and development agencies.

5. Sustainability.

The implementation of the Transportation Project is designed to support the development of local capacity (yet maintain tight fiduciary risk controls) by providing Honduran professionals and institutions with experience in implementing the Program. This design is expected to add to Honduras's soft infrastructure — the human capital base that is essential for the successful design, management and oversight of public and private projects. While most procurement for the Transportation Project will be managed by a private firm that will be selected through an international competitive bidding process, local staff will be involved in each step of the process.

While all contracts will be open to international bidding, local and regional firms are expected to be very competitive in most activities. Even in activities where an international firm may win the contract, there will be opportunities to employ Honduran individuals or firms under those contracts. Construction contracts for the secondary roads will be relatively small contracts in which national and regional firms will be competitive. The Program also contemplates opportunities for small and medium size enterprises to participate in the maintenance of the roads, through coordination by the Road Fund.

In terms of developing the institutional capacity in the Honduran transportation sector, both the World Bank and IDB have, in recent years, funded programs to restructure and develop SOPTRAVI, activities from which the Transportation Project will benefit. These activities include building capacity to manage the transportation sector, strengthening investment selection (e.g., analytical capabilities, economic evaluation, etc.), introducing an emphasis on maintenance, and expanding the capacity of the private sector in the provision of transport services (e.g., maintenance contracting). In addition, the institutional framework for transportation now has a safety component. A bill before the Honduran Congress calls for establishing a national road safety council, establishing road safety units, implementation of an accident reporting system, police enforcement of traffic laws, and providing funding for road safety.

The key issue with respect to financial sustainability of the Transportation Project is road maintenance. The Road Fund is the agency responsible for routine, periodic and emergency road maintenance. The Road Fund, funded by a fixed charge on fuel sales, prepares annual road network maintenance plans, establishes and maintains road maintenance budgets, and executes the maintenance plan. As of 2002, the portion reserved for road conservation may not be less than 40%, and the Government has been increasing the funds devoted to road maintenance through the Road Fund. A condition precedent in the Disbursement Agreement for the continued disbursement of funds will be that the Government meet certain funding and maintenance targets. The Government has stated its intention to continue increasing the funds for maintenance to achieve 75% coverage by the end of 2005, and 80% by the end of 2006. The Road Fund will also be responsible for the managing the contracts to operate the weight control stations. These contracts are expected to generate income for the Road Fund as all (i) trucks weighed will be charged a toll for road usage and (ii) overweight trucks will be charged a fee to be unloaded.

The key to ensuring environmental and social sustainability of the Program is ongoing public consultation to ensure optimal design and implementation and to ensure full country-ownership of the Program. The PMU will include an ESI Director whose job will be to ensure that environmental and social mitigation measures (including resettlement and gender issues) are followed for all Project Activities in accordance with the provisions set forth in the Compact and other documents. The ESI Director also will serve as the point of contact for comments and concerns of Project-affected parties regarding the implementation of all segments of the Compact, and lead the effort to find feasible resolutions to those problems. The ESI Director will convene periodic public meetings to provide implementation updates and to identify and address public concerns.

6. Policy and Legal Reform.

The Parties have identified the following policy, legal and regulatory reforms and actions that the Government shall pursue in support, and to reach the full benefits, of the Transportation Project; the satisfactory implementation of which will be conditions precedent to certain MCC Disbursements as provided in the Disbursement Agreement:

- (a) Enact adequate regulatory changes to enable the proper operation of a weight control system on the national highway network;
- (b) Approve the issuance of one or more contracts to build and operate a weight control system on the national highway network, collect any necessary tolls and fees, and conduct maintenance on the Highway CA-5 sections and secondary roads that MCC Funding is used to improve;
- (c) Enact adequate legislation on national road safety and enforcement; and
- (d) Approve legislation and budget providing adequate planning and funding for sustainable road maintenance for the Highway CA-5 sections and secondary roads that MCC Funding is used to improve, including adequate funding to the Road Fund for road maintenance (funding targets will be agreed upon in the Disbursement Agreement) consistent with a commitment to properly maintain the roads in accordance with generally accepted technical standards and to provide annual maintenance reports.

To improve its level of performance under the policy criteria identified in Section 607 of the Act and the MCA Eligibility Criteria, the Government will pursue the following legislative and policy reforms:

- (a) Enact new anti-trust legislation that reduces constraints on commerce and competition;
- (b) Enact new civil service legislation, issue the corresponding regulations, appoint the head of the new civil service supervisory authority, and satisfactorily implement the new law; and